BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PEARSON CANDY COMPANY, INC.)

Appearances:

For Appellant: Jack W. Nakell,
Certified Public Accountant

For Respondent: Burl D. Lack,
Chief Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Pearson, Candy Company, Inc., to proposed assessments of additional franchise tax in the amounts of $116.00, $116.00, $122.20 and $144.12 for the taxable years ended June 30, 1956, through June 30, 1959, respectively.

The question presented is whether salaries paid to appellant's vice president, Mrs. Fannie Pearson, in excess of $2,400 during the years in question should be allowed as deductible, business expenses pursuant to Section 24343 of the Revenue and Taxation Code which provides for a reasonable allowance for salaries or other compensation for personal services actually rendered.

Appellant corporation began business July 1, 1955. The business, that of manufacturing candy, was begun by Mr. and Mrs. Pearson in 1925. Following her husband's death in 1940, Mrs. Pearson operated the business as an individual proprietor. In 1947 she formed a partnership with her two sons, Edward and Daniel, and in 1955 transferred her interest to her sons and retired from active management. Shortly thereafter appellant was created, each son owning one-half of the stock. Edward held the office of president, Daniel, secretary-treasurer, and Mrs. Pearson, vice president.

Because of her experience, Mrs. Pearson, although retired from active management, served as consultant and advisor with respect to all phases of the business and was on the board of directors. Her services, though irregular, were frequent. In view of her previous close association with customers, principally larger markets and drug stores, she continued to maintain personal contact with them. She continued to formulate and test new products because of her familiarity with the ingredients. She gave samples to others for public testing. She surveyed the activities of competitors in retail markets.

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As of the close of the period in question, appellant had paid no dividends. Significant statistics for the income years ended June 30, 1956, to June 30, 1958, are as follows:

Year	Sales	Gross Income	Net Income	*Capital Investment	Compensation Edward	Daniel	Fannie
1957	$735,142	$287,780	$29,023	$118,978	$15,785	$15,600	$5,300
	814,319	309,376			,600		5,455
1958	995,534	386,638	43,306	131,889	18,280	18,280	6,003

(*At beginning of the year.)

Respondent regarded $2,400 as a reasonable salary for Mrs. Pearson, disallowing the deduction of the salary paid in excess thereof as being unreasonable.

What is reasonable compensation depends upon the facts and circumstances of each particular case. (Mayson Mfg. Co. v. Commissioner, 178 F.2d 115.) The burden is upon the taxpayer to prove it is entitled to the deduction. (Cresent Bed Co. v. Commissioner, 133F.2d 424; Botany Worsted Mills v. United States, 278 U.S. 282 (73 L.Ed.379).) Furthermore, the existence of a family relationship justifies a close scrutiny of the facts. (L. Schepp Co., 25 B.T.A. 419; Em. H. Mettler & Sons, T. C. Memo., Dkt. No. 12624, March 30, 1949, aff'd, 181F.2d 848, cert. denied, 340 U.S. 877 (95 L.Ed. 637); Appeal of National Envelope Corp., Cal. S-t. Bd. of Equal., Nov. 7, 1961, CCH Cal. Tax Rep. Par. 201-860, P-H State 6 Local Tax Serv. Cal. Par. 13263; J.W. Boyt, 18T.C. 1057, aff'd on other grounds, 209F.2d 839.)

Mrs. Pearson's many years of experience made her services uniquely valuable. (Estate of Morton Alpirn, T.C. Memo., Dkt. No. 46413, March 31, 1959; The Wm. A. Howe Co), T. C. Memo., Dkt. No. 6022, October 10, 1945; Savinar Co., 9 B.T.A. 465.) The services of an experienced advisor and consultant are valuable even though furnished irregularly. (Savinar Co., supra; Smoky Mountains Beverage Co., 22 T.C. 1249; Howard Theatre Co., 16 B.T.A. 57.) The continuation of Mrs. Pearson's personal relationship with most of appellant's customers undoubtedly materially assisted appellant. (The Wm. A. Howe Co., supra.)

Furthermore, the fact that there were net returns of 29.1 percent, 20.1 percent and 32.8 percent on invested capital after salaries for the years in question supports the conclusion that the compensation was reasonable. (Appeal of Redding Moulding Co., Cal. St. Bd. of Equal., Nov. 14, 1960, CCH Cal. Tax Rep. Par. 201-633, P-H State & Local Tax Serv. Cal. Par. 13235; Klug & Smith Co., 18 B.T.A. 966; Olympia Veneer Co., 22 B.T.A. 892.) The salary was also reasonable when compared with gross sales. (Appeal of Miss Saylor's Chocolates, Inc., Cal. St. Bd. of Equal., Aug. 4, 1930.)

The family salary opinions cited by respondent present factual situations different from the matter under consideration. In L. Schepp Co., supra, the services of the daughter were slight and her experience limited. Even so, a $4,000 salary was allowed for the year 1918. In Em. H. Mettler & Sons, supra, equal payments were made to the stockholders regardless of the differences in their experience, age, duties, and education. The salaries allowed, furthermore, were from $8,000 to $20,000 in 1942, amounts in excess of Mrs. Pearson's modest salary. In Appeal of National Envelope Corporation, supra, the son's experience and the value of his services were considerably less than in the case before us. In Boyt, supra, the record was meager

concern ing the serv ices per formed. Furthermore, the sal ary al lowed was still $3,000 in the year 1942 when the general level of compensation due to the lower cost of l iv ing was iess than during the years here involved.

Respondent cl aims appel lant would not have employed another if Mrs. Pearson's services were not available, and therefore asserts the expend i ture was not necessary, as required pursuant to sect ion 24343. However, a necessary expense with in the meaning of the statute is one which is sppropr iate and helpful; it need not be essential. (Blackmer v. Commissioner, 70 F.2d 255.) If appell ant woul d not have empl oyed another it is because no other person had Mrs. Pearson's special experience in appellant's business, as, for example, in the area of customer contacts.

Viewing the evidence in its entirety, we conclude that the salary paid to Mrs. Pearson during each of the years in question was reasonable and necessary within the meaning of section 24343.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to sect ion 25667 of the Revenue an4 Taxation Code, that the action of the Franchise Tax Board on the protests of Pearson Candy Company, Inc., to proposed assessments of additional franchise tax in the amounts of $116.00, $116.00, $122.20 and $144.12 for the taxable years ended June 30, 1956, through June 30, 1959, respectively, be and the same is hereby reversed.

Done at Sacramento, Cal ifornia, this 10th day of December, 1963, by the State Board of Equal ization.

John W. Lynch, Cha irman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

, Member

ATTEST: H.F. Freeman, Secretary